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In the Supreme Court of the United States.

OCTOBER TERM, 1916.

FRED VON BAUMBACH, COLLECTOR OF Internal Revenue, petitioner, *v.* SARGENT LAND COMPANY.	No. 286.
FRED VON BAUMBACH, COLLECTOR OF Internal Revenue, petitioner, *v.* SUTTON LAND COMPANY.	No. 287.
FRED VON BAUMBACH, COLLECTOR OF Internal Revenue, petitioner, *v.* KEARSARGE LAND COMPANY.	No. 288.

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT.

BRIEF FOR PETITIONER.

STATEMENT OF THE CASE.

At some early time the Pillsbury brothers became the owners of large tracts of land in Minnesota (R. 44). After removing the timber they

sold undivided interests in the land, with a view of developing its ore deposits, to Bennett and Longyear (R. 45). Subsequently, and prior to 1902, the undivided interests of the Pillsburys passed, on their deaths, to their respective devisees, whose interests were in some cases as small as 216ths, and some of whom were minors (R. 45, 46). Under the laws of Minnesota a minor can not make a lease for more than 25 years (R. 46). As ore leases are usually made for a longer period, and as such small fractional interests prevented the efficient handling of the property, it was determined to form corporations and to issue to the owners so much stock therein as would exactly represent the undivided interest of each (R. 47). Because the amount of land owned was in excess of what the laws of Minnesota permitted one corporation to own (R. 47) these three respondent corporations were formed about February 20, 1906 (R. 1, 13, 25). The original articles of each provided (R. 8, Art. I):

> The general nature of its business shall be the buying, owning, exploring and developing, leasing, improving, selling and dealing in lands, tenements and hereditaments, and the doing of all things necessary or incidental to the things above specified.

This provision was amended December 29, 1909, to read (R. 3):

> The general purpose of the corporation is to unite in one ownership the undivided fractional interests of its various stock-

> holders in lands, tenements and hereditaments, and to own such property; and, for the convenience of its stockholders, to receive, and distribute among them the proceeds of any disposition of such property at such times, in such amounts, and in such manner, as the board of directors may determine.

Article X (after stating that the title to the property was in two classes (1) the heirs and devisees of the Pillsburys, and (2) Bennett and Longyear), recited (R. 10):

> this corporation having been formed, by mutual agreement of all said owners of both classes, for the more convenient handling, improvement, development and disposition of said properties, etc.

Prior to the organization of these corporations certain so-called mining leases had been made by the owners (R. 46), of which plaintiff's Exhibit 15 is a sample (R. 97, 98). Probably all the leases had been negotiated prior to the organization of the corporations (R. 50, 51), but one of the most important (plaintiff's Exhibit 16) was actually executed by the Sargent Land Company on January 2, 1907 (R. 50). These leases do not differ in any material respect from the ordinary form of mining lease used generally in this country. They "lease and demise" or "let and demise" certain lands for the purpose of exploring and taking out "the iron ore," "the merchantable iron ore" therein. One lease is for a term of 50 years, and the

other is until all merchantable ore grading 49 per cent and upward has been mined and shipped. In one lease the lessee agrees to pay " as rent or royalty " 25 cents a ton. In the other the lessee agrees to make graded payments of certain amounts per ton " as royalty." Both leases provide for minimum payments by the lessee in any event. Since the lessee is bound by elaborate stipulations to drill honestly for ore, to remove the ore in a proper manner, and to keep accurate accounts so that the royalty may be properly determined, the lessor reserves the right to enter on the land and drill for itself, also to inspect the workings; and the lessee is obligated to render daily and monthly statements as to the ore mined and the ore shipped. The leases contain the usual provisions as to the lessor's right to reenter and repossess on breach by the lessee of its agreements; they provide that tenants' fixtures shall not be removed; and a lien is reserved on the ore till it is sold.

The rights thus reserved to the lessor corporations they constantly exercised during the taxing years in question. They incorporated a company to inspect the operations of the lessees, and such inspections were regularly made (R. 55, 57–59). The controversy between the Kearsarge Land Company and the Oliver Mining Company, which appears on pages 77 to 80 of the record, is a fair example of the close attention and supervision given by these lessors to the operations of the lessees; and this was natural and necessary, since the amount

of their royalty depended on the extent to which, and the manner in which, the lessees mined the ore. In addition, the corporations did other things during the taxing years in question which space does not permit a rehearsal of. Their various activities are correctly set out by the district judge in his opinion (R. 115, 116).

After the passage of the corporation tax act the corporations claimed that they were not liable thereto because they were not doing business and had no income (R. 3). Being compelled to make a return, they filed one showing depreciation in excess of their gross income (R. 4, 5). The Government nevertheless assessed a tax upon them, the basis of which was the gross income from royalties, etc., deducting the items allowed by the act, e. g., expenses, taxes, etc. (R. 5, 107, 108). No allowance was made for depreciation, and none was claimed by the companies except for waste or depletion of capital (R. 107–112). No actual allowance or charge for such so-called "depreciation" was ever made by them on their books of account (R. 49, 108).

The companies paid the tax assessed and brought these actions to recover it. The district judge held that the companies were "doing business" within the meaning of the corporation-tax act. He held, however, that the rentals received were not income, but were return of capital, and rendered judgment for the full amount claimed by plaintiffs. (R.

113–124.) The Circuit Court of Appeals affirmed the judgment (219 Fed. 31), holding (*a*) that the companies had no income, since the payments were merely capital payments; (*b*) that a mining lease is not a lease at all, but a sale of the ore payable in installments, and hence the rentals are not income; (*c*) that the companies merely owned the right to the purchase price of the ore, as in the case of a person owning promissory notes payable in different years without interest, and that the annual payments could not be called income; (*d*) that the companies were not "doing business" within the meaning of the act.

ARGUMENT.

I.

THE RESPONDENTS WERE "DOING BUSINESS" WITHIN THE MEANING OF THE CORPORATION-TAX ACT.

This depends on whether the cases fall within *Mitchell* v. *Clark Iron Co.*, 220 U. S. 107, 170, or within *United States* v. *Emery, Bird, Thayer Realty Co.*, 237 U. S. 28.

In *Mitchell* v. *Clark Iron Co.* the bill of complaint alleged—

> that the company was incorporated under the laws of Minnesota (ch. 28, Laws 1876) and was authorized to own and hold real estate; that it was the owner of certain lands in Minnesota which it had explored for iron; * * *.

That the defendant Clark Iron Company some years ago made explorations for iron ore upon the lands hereinbefore described, or some portion thereof, and caused explorations and developments to be made thereon, resulting in the discovery of large bodies of iron ore in said premises, or some portion thereof.

That for more than three years last past the said lands upon which such deposits of iron ore have been discovered, have been leased to other parties or corporations for the purpose of carrying on mining operations thereon and taking out and removing iron ore, in consideration of the payment to the said defendant Clark Iron Company of rents or royalties based upon the iron ore so mined and removed, *and that for more than three years last past the said defendant Clark Iron Company has not engaged in any business other than to watch over and care for the said lands and receive the rents and royalties accruing therefrom and distribute the same to its stockholders by means of dividends,* except such business as has been necessary to transact in defending its title to the said premises, in which the said defendant has incurred large expense, the amount of which is unknown to this plaintiff, and that the only income the said defendant company has had for more than three years last past has been by way of rent and revenue from the said lands, accruing by and thru the leasing thereof for iron mining purposes

> by way of rental paid by the lessees on a royalty basis upon the iron ore mined and removed from said lands. [Italics ours.]

The case was tried on demurrer, so that these were the only facts before the court. This court, after stating these facts as to the nature of the business done by the company, said (220 U. S. 171):

> We think it is clear that corporations organized for the purpose of doing business, and actually engaged in such activities as leasing property, collecting rents, managing office buildings, making investment of profits, *or leasing ore lands and collecting royalties,* managing wharves, dividing profits, and in some cases investing the surplus, are engaged in business within the meaning of this statute, and in the capacity necessary to make such organizations subject to the law. [Italics ours.]

In the *Emery, Bird, Thayer Realty Company* case this court said (237 U. S. 32, 33):

> * * * The question is rather what the corporation is doing than what it could do, 228 U. S. 305, 306, but looking even to its powers they are limited very nearly to the necessary incidents of holding a specific tract of land. The possible sale of the whole would be merely the winding up of the corporation. That of a part would signify that the Dry Goods Company did not need it. *The claimants' characteristic charter function and the only one that it was carrying on was the bare receipt and distribution to its*

> *stockholders of rent from a specified parcel of land. Unless its bare existence as an intermediary was doing business, it is hard to imagine how it could be less engaged.* [Italics ours.]

The cases at bar fall directly within *Mitchell* v. *Clark Iron Company*. In that case it was alleged that all the leases had been made more than three years prior to the filing of the complaint, February 10, 1910, so that since the passage of the corporation-tax act the company had done nothing but watch over its lands and collect its royalties. The case is decisive here.

In the *Emery, Bird, Thayer Realty Company* case, while it is true that the corporation was carrying out the functions for which it was incorporated, those functions were purely passive. The corporation was a mere conduit pipe. It was as though it had been incorporated merely to collect the interest on investments, to receive income, so that it could be reached, not by an excise but only by an income tax. In the cases at bar the companies were incorporated for the very purpose of getting, in the operation and management of mining leases, the advantage of a legal person over minors and undivided interests. The corporations supplied the main capital—the land. The lessees supplied the labor and, so to speak, the working capital. The product was divided between them. This arrangement constituted a community of in-

terest between lessors and lessees and required the corporations to do what they did—namely, exercise a constant supervision over the business to see that they obtained their just royalties.

This is clearly brought out by the testimony of Bennett (R. 95, 96), that while sometimes ore lands or the ore itself are sold for a lump sum, the lessee prefers to pay a much larger sum as royalties to a smaller lump sum, because in the former way payments need not be made till the ore is marketed. This shows that the object of a mining lease is to divide up the mining business, the lessor furnishing most of the capital. It is not, therefore, like the case of a corporation leasing all of its property, including its franchises, and retiring from business, or the case of a corporation which merely receives ground rent from an investment. The facts as to "doing business" in the present cases are fully brought out in the opinion of the district judge (R. 115–117), and it seems impossible to add anything thereto.

II.

A MINING LEASE IS NOT A SALE ON INSTALLMENTS, AND THE ROYALTIES THEREON ARE INCOME.

(*a*) The Court of Appeals in deciding that a mining lease was a sale relied entirely upon a remark of Lord Blackburn in *Coltness Iron Co.* v. *Black,* 6 App. Cas. 315, 335, and on certain Pennsylvania cases (219 Fed. 38, 39). Lord Black-

burn, however, concluded the remarks quoted as follows:

> But the argument that no income tax should be imposed on what is, perhaps not quite accurately, called rent reserved on a mineral lease, because it is a payment by instalments of the price of minerals forming part of the land, any more than on the price paid down in one sum for the out and out purchase of the minerals forming part of the land, is, I think, untenable.

As to the Pennsylvania cases, the Court of Appeals failed to notice *Denniston* v. *Haddock,* 200 Pa. St. 426, 428, where the court, after referring to the cases relied on by the Court of Appeals, said of mining leases:

> Whether it would be better to call such an instrument accurately what it certainly was at common law, a lease without impeachment of waste, or to endeavor to reconcile all the decisions by calling it a conditional sale, is not necessary at present to discuss. The point to be noted is that the rules applicable to sales are not to be applied indiscriminately to such instruments, but each is to be construed like any other contract by its own terms.

Outside of the peculiar Pennsylvania cases, referred to by the Court of of Appeals, the authorities are uniform that a mining lease is not a sale and that the rents or royalties thereon are income. *United States* v. *Gratiot,* 14 Pet. 526, 538, 539; *Hyatt* v. *Vincennes Bank,* 113 U. S. 408, 416; *Ray-*

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The case of *United States* v. *Gratiot, supra,* is not cited by the Court of Appeals and is really decisive of the question. Moreover, in the case of *Niles Land Co.* v. *Chemung Iron Co.* et al., 234 Fed. 294, this same Court of Appeals, though consisting of different judges, clearly held an instrument dealing with iron ore in Minnesota, precisely similar to plaintiff's Exhibits 15 and 16 in the present case, to be a lease.

It is said (219 Fed. 42) of some of these decisions that they arose under wills and depended therefore merely on the intent of the testator, but there were in them no special indications of the testator's intention, and he was merely presumed to have meant by royalties in mining leases what everybody else meant thereby.

(*b*) Prior to the time the rights of the United States accrued the Supreme Court of Minnesota had decided, in *State* v. *Evans,* 99 Minn. 220, that a mining lease is not a sale but a lease, and that

the royalties on it are true rents or profits accruing from the land, and this was affirmed in *Boeing* v. *Owsley,* 122 Minn. 190. Subsequently in the case of *State of Minnesota* v. *Royal Mineral Association,* 156 N. W. 128, the decision of the Court of Appeals in the present case was called to the attention of the Supreme Court of Minnesota, and that court declined to follow it, holding that the Pennsylvania decisions relied on by that court had been overruled; that the amounts stipulated to be paid by the lessees in mining leases were " rents," and were *taxable* as such. The decision in *State* v. *Evans* made a rule of property in Minnesota, and the Court of Appeals was bound to follow it. *Bucher* v. *Cheshire R. R. Co.,* 125 U. S. 555, 583; *Clarke* v. *Clarke,* 178 U. S. 186; *Abraham* v. *Casey,* 179 U. S. 210, 218; *East Cent. E. M. Co.* v. *Cent. Eureka Co.,* 204 U. S. 266, 272; *Kuhn* v. *Fairmont Coal Co.,* 215 U. S. 349, 360; *Foster* v. *Elk Fork Oil & Gas Co.,* 90 Fed. 178, 182; *York* v. *Washburn,* 129 Fed. 564, 567; *Fretts* v. *Shriver,* 181 Fed. 279.

It is contrary to all principle to have a mining lease of land in Minnesota called a sale if the question arise in the United States District Court for Minnesota, and a lease if it arise in a State court.

(*c*) If, then, these instruments were leases, and the royalties received by the corporations were " rent," there can be no doubt that such rentals, when received, constituted gross income of the lessors. Indeed *Mitchell* v. *Clark Iron Co., supra,*

is decisive on this point, since this court must have held, in order to render the decision it did in that case, that the royalties were income.

(*d*) If this court be disposed to consider the matter without reference to *Mitchell* v. *Clark Iron Co.*, the same conclusion must be reached. Whether these " royalties " are called payments by installment of a debt, or conversion of capital from one form to another, they were, nevertheless, received by the companies during the taxing years in question from the business done by them with the advantages inherent in a corporate organization. They were the gross income of the companies from such business, since gross income is nothing but gross money receipts or revenue. They are therefore within the very language of the act. *Anderson* v. *Forty Two Broadway Co.*, 239 U. S. 69. For this reason the two cases mainly relied on by the court of appeals are inapplicable.

In *Secretary of State* v. *Scoble*, (1903) 1 K. B. 494, (1903) A. C. 299, the Secretary of State for India purchased a railroad and exercised an option to pay for it in installments. It was held that these payments of a debt were not " profits and gains " for the year in which they were paid. This has no analogy to the periodical payments received in the present case in the regular course of the companies' business, and varying with the operation of that business. Hence the Lord Chancellor in the *Scoble case* distinguished it from the case of

an income tax on rent derived from coal (1903 A. C. 303). In *Stevens* v. *Hudson's Bay Co.*, 101 Law Times Rep. 96, it was distinctly held that the company in selling the lands was not engaged in a trade or business, and that if it had been engaged in selling lands as a business it would have been liable to the tax. So in *Gray* v. *Darlington*, 15 Wall. 63, 66, the majority of the court, in holding that the conversion of capital from one form into another was not gains, profits, or income of the year in which the conversion took place, pointed out that the rule would be different where the conversion took place in the regular course of business. This same distinction is thus clearly stated in *Stratton's Independence Limited* v. *Howbert*, 231 U. S. 399, 414, 415:

> * * * It is not correct, from either the theoretical or the practical standpoint, to say that a mining corporation is not engaged in business, but is merely occupied in converting its capital assets from one form into another. The sale outright of a mining property might be fairly described as a mere conversion of the capital from land into money. But when a company is digging pits, sinking shafts, tunneling, drifting, stoping, drilling, blasting, and hoisting ores, it is employing capital and labor in transmuting a part of the realty into personalty, and putting it into marketable form. The very process of mining is, in a sense, equivalent in its results to a manufacturing process. And,

> however the operation shall be described, the transaction is indubitably " business " within the fair meaning of the act of 1909; and the gains derived from it are properly and strictly the income from that business; for " income " may be defined as the gain derived from capital, from labor, or from both combined, and here we have combined operations of capital and labor. * * *

This view is adhered to in *Stanton* v. *Baltic Mining Co.,* 240 U. S. 103, 114, where it is said that a tax on the product of a mine " is not a tax upon property as such because of its ownership, but a true excise levied on the results of the business of carrying on mining operations."

The fact, therefore, that money is received by a corporation in satisfaction of some previously accrued right to its payment, or that it is received as one side of a conversion of capital, is not conclusive that it is not " gross income " under an excise tax measured by such income. If the money has been received in the regular course of a business carried on with the advantages inhering in corporate organization it falls within the terms of the act, and of course Congress had power to fix the measure of corporate advantage in business by money received from capital conversion, or money received in extinguishment of prior rights, as well as by any other rational system. *Society for Savings* v. *Coite,* 6 Wall. 594; *Prov. Inst.* v. *Mass.,* id. 611; *Ham. Co.* v. *Mass.,* id. 632; *Spreckels Sugar Refining Co.* v. *McClain,* 192 U. S. 397.

III.

THE RESPONDENTS ARE NOT ENTITLED TO ANY ALLOWANCE FOR "DEPRECIATION."

(A) "Depreciation" can not be "allowed" under the act unless, and only to the extent that, actual deductions or payments have been made on account of it.

This is clear on general principles. Just as "income" must be an actual, not a hypothetical, receipt, so "outgo" must be an actual, not a hypothetical, payment. Just as the appreciation in value of property, *e. g.* rise in value on the stock exchange, does not constitute "income," so depreciation in value, *e. g.* fall in value on the stock exchange, does not constitute "outgo." A terminable annuity, *e. g.* a pension, diminishes in value steadily as the period of its termination approaches, and yet no deduction can be made from its "income" on that account, unless a portion of said income is actually set aside for that purpose. The human machine is constantly wearing out, and yet no deduction can be made on that account, unless actual payments are made for insurance. The same is true of "capital" invested in patents, and of many other businesses. It can not be said that the man who allows his house to go to pieces, spending nothing for repairs, is yet entitled to the same deduction from his "income" as the prudent owner who spends enough from his income each year to keep his house in perfect condition.

Turning to the actual language of the act, it may be admitted that it is not entirely clear; but